199938036

Internal Revenue Service

Department of the Treasury

Index Number: 162.00-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:IT&A:05-PLR-105882-99
Date:
JUN 24 1999

TY: 99

State	=
A	=
b	=
c	=
D	=
Decision	=
Federal Agency	=
State Agency	=
Payment Years	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
$f	=
$g	=
h%	=
$j	=
$k	=
$m	=
Statute	=
Act	=

Dear

This responds to your request dated March 12, 1999, for a ruling on the tax treatment of certain payments made or to be made by Taxpayer to A. Specifically, you have asked for a ruling that:

> The annual payments made or to be made by Taxpayer to A are deductible under section 162(a), in the Payment Years, as payment is made to A.

Taxpayer is a b incorporated in State, and is engaged primarily in the production and sale of c, principally in the central and southern portions of State. Taxpayer is subject to regulation by State Agency and Federal Agency. Taxpayer uses an accrual method of accounting on a calendar year basis.

FACTS

The facts, as represented by Taxpayer, are as follows. On Date 1, State Agency issued the Decision, setting forth its plan for increasing competition within Taxpayer's industry. The overarching goal of competition was to help control the cost of c within State.

State Agency has taken three major steps towards this goal, including the formation of A and D. A and D are intended to facilitate the entry of new competitors into Taxpayer's industry. Specifically, A will serve as a clearinghouse for c transactions.

The purpose of A is to encourage and permit rival producers to compete on a fair basis within common territory. The Decision set forth the following specific requirements and duties for A.

1. A is not to have any financial interest in any source of production of c. This would ensure that A will have no bias in favor of or against any specific producers of c.

2. A is not to have any ownership ties to D.

3. A will determine on a forecast basis the needs of specified categories of customers.

4. A will function as a clearinghouse by providing a transparent auction for c production with price signals evident to immediate users and long-term

5. A will formulate nondiscriminatory rules that permit rival producers to compete on common grounds using transparent rules for bidding into A.

State has enacted legislation endorsing the establishment of A. The Act directed that A be a public benefit, non-profit corporation under State law. A was organized according to the directives of the Act and it applied for and received tax-exempt status under section 501(c)(4) of the Internal Revenue Code. A has no equity and no capital stock. Accordingly, Taxpayer has no ownership or control over A. The activities of A, as mandated by the Decision and the Act, have generated costs approximating $f.

The Decision ordered Taxpayer to work with other interested parties to prepare a joint proposal to establish A. The Decision also ordered that, during a transition period, Taxpayer must bid all of its c production into A and purchase all of the c needed for its customers from A. The Act prescribed the transition period as ending on Date 2. After the end of the transition period, Taxpayer will no longer be required to sell to or to acquire its c from A, and instead will be free to buy and sell c using any method available to it.

On Date 3, State Agency issued a decision authorizing the establishment of two trusts, one to control the development of A and one to control the development of D. The decision required each of the trusts to obtain loans to provide funding for the establishment of each respective entity and to provide for the acquisition of the necessary computer hardware and software and other infrastructure costs. The decision further required each of the b's operating in State to guarantee the loans. The total amount of the loans approved by State Agency was $g and the Taxpayer's share of the loan guarantee was set at h% or $j. The decision did not identify how much was to be for A and how much was to be for D. During the transition period, Taxpayer would share a seat on the board of directors of A. The decision also provided that any costs actually incurred by Taxpayer under the loan guarantees would be recoverable from its customers.

On Date 4, A filed an amended application with Federal Agency requesting that its share of infrastructure costs be collected from the b's through annual payments in lieu of the loan guarantees. A and the b's entered into an offer of settlement under which the amount of the b's contribution to A and the payment schedule was determined. The offer of settlement was certified by an administrative law judge on Date 5, and is currently pending final approval by Federal Agency. Under the offer of settlement, Taxpayer and the other b's were assessed a charge to be paid in annual installments. Payment of these amounts would coincide with the years in which Taxpayer is required to use A to buy and sell c. Each of the annual payments from the

b's would total $k, of which Taxpayer's h% share would be $m, plus specified interest charges and administrative expenses.

Although the Decision and the Act require Taxpayer and the other b's to bear the costs of the programs designed to introduce new competitors into their markets (including the costs of A and D), the Act provided for c prices to be frozen. In effect, the Taxpayer asserts, the b's were required to fund these programs, as well as other costs, without the benefit of a price increase to recover the costs. State Agency has responded by reaffirming Taxpayer's ability to use the Statute to facilitate its ability to recover the costs from its customers in future years.

LAW AND ANALYSIS

Section 162(a) provides, in part, that taxpayers may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a) of the Income Tax Regulations.

Section 162(b) prohibits a deduction under § 162(a) for any contribution or gift that would be allowable as a deduction under § 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment set forth in § 170.

Section 263(a) prohibits a deduction for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. See also § 1.263(a)-1(a).

Section 161 clarifies the relationship between deductions allowable under § 162 and capital expenditures under § 263. Section 161 provides that the deductions allowed in Part VI of the Code (which includes § 162), are subject to the exceptions set forth in Part IX (which includes § 263). Thus, the capitalization rules of § 263 take precedence over the rules for deductions under § 162, with the result that an expenditure that is otherwise an ordinary and necessary business expense under § 162 must be capitalized if it is also a capital expenditure under § 263. See also Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974). Under these rules, the Supreme Court has held that taxpayers must capitalize the costs of creating or acquiring a separate and distinct asset with a useful life extending substantially beyond the end of the taxable year. See Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345, 354 (1971). In addition to this "separate and distinct asset" standard, the Supreme Court has held that taxpayers must capitalize costs under § 263 if they generate significant future benefits. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87-88 (1992).

172

The INDOPCO decision clarifies that the creation or enhancement of a separate and distinct asset is not a prerequisite to capitalization. That clarification does not, however, change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized. As the Supreme Court has specifically recognized, the "decisive distinction [between capital and ordinary expenditures] are those of degree and not of kind." Deputy v. du Pont, 308 U.S. 488, 496 (1940); Welch v. Helvering, 290 U.S. 111, 114 (1933); see also INDOPCO, 503 U.S. at 87.

Under the facts presented, Taxpayer's payments to A do not result in the creation or the acquisition of a separately identifiable asset. Taxpayer acquires no ownership interest in A nor any other rights or interests in the entity. Further, there is no indication that Taxpayer will derive a significant future benefit from its payments. First, the primary purpose underlying the creation of A is State's efforts to control the price of c by facilitating the introduction of new competitors into the marketplace. There is no evidence that the introduction of new competitors constitutes a long-term benefit to Taxpayer. Second, its payments to A do not entitle Taxpayer to receive any special benefits from A that are not available to all other buyers and sellers of c. Although Taxpayer will be entitled to recover the amount of the payments from its customers, the Service previously has ruled that such an entitlement does not *per se* require capitalization of the payments. See, e.g., Rev. Rul. 95-32, 1995-1 C.B. 8 (permitting current deduction for costs of demand-side management program which could be recovered through ratemaking).

Accordingly, on the facts presented, Taxpayer's annual payments to A do not result in the creation or acquisition of a separate and distinct asset, nor do they confer upon Taxpayer any long-term benefits of the sort which would require capitalization under the Supreme Court's INDOPCO decision.

Escaping the Code's capitalization requirements, however, is not sufficient to support a current deduction. Instead, Taxpayer also must show that the expenditure meets the requirements of section 162. In order to be deductible under section 162, an expenditure must be (1) paid or incurred during the taxable year, (2) related to carrying on a trade or business, and (3) ordinary and necessary for the trade or business. Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345 (1971). There is no question the payments relate to Taxpayer's trade or business. Further, Taxpayer acknowledges that a deduction is allowable, if at all, only in the year of payment. See § 1.461-4(g)(7). The only issue then is whether the payments are "ordinary and necessary." On the facts presented, Taxpayer has made the necessary showing.

First, the payments are "ordinary." The Supreme Court has indicated that the term "ordinary" refers to an expenditure that is normal, usual, or customary. Deputy v.

du Pont, 308 U.S. 488, 495 (1940). Moreover, the Court has stated that an expense may be ordinary even if it only occurs once in a taxpayer's lifetime provided that the expenditure is commonly and frequently incurred in the type of business involved. Id. (citing Welch v. Helvering, 290 U.S. 111, 114 (1933)). Although the nature of the payments to A occurred in the course of a relatively unique factual circumstance, State Agency's imposition of the payments upon all similarly situated members of Taxpayer's industry suggests that the payments are ordinary, despite the fact that such a charge may never be imposed on Taxpayer again.

Second, the payments are "necessary." The term "necessary" means appropriate and helpful to the development of the taxpayer's business. Commissioner v. Tellier, 383 U.S. 687, 689 (1966); Commissioner v. Heininger, 320 U.S. 467, 471 (1943). In this case, the payments are appropriate and helpful to Taxpayer's business, in that payment was mandated by the governmental entity which confers upon Taxpayer the right to conduct business operations in State, and its failure to comply could jeopardize its continued business operations. See, e.g., Rothner v. Commissioner, T.C. Memo 1996-442. Although an enforceable obligation to make payment is not *per se* sufficient to establish that a payment is ordinary and necessary, Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943), we believe that on the facts at issue this requirement is satisfied.

In addition, based on the facts presented, Taxpayer had no donative intent in making the payments to A, so that the payments are not deductible as a charitable contribution or gift under § 170. Accordingly, Taxpayer's deduction under § 162(a) is not prohibited by the exception provided in § 162(b) for contributions and gifts under § 170.

Therefore, in accordance with the foregoing facts, we conclude that the annual payments made or to be made by Taxpayer to A are deductible under Code section 162(a), in the Payment Years, as payment is made to A.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

174

A copy of this letter must be attached to any income tax return to which it is relevant.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

for David L. Crawford
Chief, Branch 5